

# **The State Fiscal Management Reform Assessment Team's Report**

## **Purpose of the India State Fiscal Management Reform Assessment**

The USAID/India Mission is presently in the process of formulating a new five-year development strategy for India. During the next six months the Mission will complete a variety of detailed sector assessments that will serve as the basis for developing specific sector activities that will be included in the new Strategy. The objective of the State Fiscal Management Reform Assessment is to pull together the factual information needed to establish pragmatic and realistic suggestions for USAID to consider as a means to increase the capacity of selected state governments to improve fiscal management.

## **Organization of the Report**

This report gives a basic, non-technical overview of the main findings of the Assessment Team. In addition, there are 10 technical Annexes that deal more extensively with the major issues:

- Annex I: Approach (Terms of Reference)
- Annex II: Overview of India's Fiscal Situation
- Annex III: Major Contributors to State Fiscal Deficits
- Annex IV: GOI and International Assistance to State Fiscal Management Reform
- Annex V: Decentralization
- Annex VI: Three Case Studies: Jharkhand, Karnataka, and Uttar Pradesh
- Annex VII: Overview of Management Information Systems in Three States
- Annex VIII: An Overview of Treasury Systems
- Annex IX: The Fiscal Planning and Analysis Cell
- Annex X: Checklist for Sound Fiscal Management

Finally, for the reader's convenience we include the following Annexes:

- Annex XI: List of Interviews
- Annex XII: References
- Annex XIII: List of NGOs in Jharkhand
- Annex XIV: Jharkhand Organizational Setup
- Annex XV: The States' Fiscal Reforms Facility (2000-01 to 2004-5)
- Annex XVI: Personnel Qualifications.

## **Terms of Reference**

The complete terms of reference (TOR) for the State Fiscal Management Reform Assessment are provided in Annex I. The Team distilled the TOR into three fundamental questions:

1. What is the nature of the problem with State finances?

2. Is there a role for USAID in this area?

3. If so, where can USAID add value?

In order to address these basic questions, a team of four specialists traveled to India between October 4<sup>th</sup> and November 2<sup>nd</sup>, 2001. The team consisted of a macroeconomist with a focus on public finance (Dr. Bahl); local expert on Indian State finances (Dr. John Kurian); public finance specialist (Dr. Mark Rider); and a public sector enterprise specialist (Mr. Michael Schaeffer). For your convenience, brief biographical descriptions of each team member and their vita are provided in Annex XVI.

The following is a brief description of the Team's approach to the State Fiscal Management Reform Assessment. The Team's time in the field can be broken down into two parts. The first week was spent in Delhi interviewing officials of the Government of India (GOI), representatives of bilateral and multilateral donors, specifically Asia Development Bank (ADB), the United Kingdom's Department of International Development (DFID) and the World Bank (WB), and scholars affiliated with local fiscal "think tanks."

The team also had lengthy discussions with members of the USAID Mission in order to develop an assessment strategy that would be responsive to the needs of the Mission. During this initial phase of the field work, the team focused on three specific issues: soliciting a variety of views on the nature of the problem with state finances; developing a list of potential interventions; and assessing the opportunity for USAID to collaborate with other donors on activities related to State fiscal restructuring.

During the second phase of the Assessment - weeks 2 through 4 - the team visited three states: Karnataka, which is a fast reforming state; Jharkhand, which is a newly formed state; and Uttar Pradesh, which is a slow reforming state. The team interviewed State representatives from the Departments of Finance, Planning and a variety of sector departments, such as health, power, water and rural and urban development. In addition to soliciting the ideas of local officials on potential USAID interventions, the Team discussed their reaction to the list of interventions developed by the Team during week 1 in Delhi. Finally, we collected factual information on the fiscal condition of each State, discussed their priority needs and tried to assess each state's absorptive capacity. A complete list of the people interviewed during this four-week period is provided in Annex XI. Annex XII provides a list of the reference materials used in this Assessment.

### **What is the Nature of the Problem with State Finances in India?**

As shown in Table 1, throughout the past decade State revenues as a share of GDP (column 2) have been declining more rapidly than the share of state expenditures (column 1). The obvious consequence of this trend in State finances is a widening gap between expenditures and revenues or, in other words, growing State Revenue Deficits (column 3). The States have been financing these Revenue Deficits (RD) by borrowing money, which results in rising State debt (column 4).

**Table 1: A Few Key Indicators of State Finances**

Year	State Expenditure (% of GDP)	State Revenue (% of GDP)	Revenue Deficit (% of GDP)	State Debt (% of GDP)
1990-91	13.2	11.6	1.6	19.47
1991-92	12.9	12.3	0.6	19.37
1992-93	12.9	12.2	0.7	19.04
1993-94	12.7	12.3	0.4	18.63
1994-95	12.7	12.1	0.6	18.27
1995-96	12.3	11.6	0.7	18.72
1996-97	12.4	11.2	1.2	17.88
1997-98	12.4	11.2	1.2	18.53
1998-99	12.5	10.0	2.5	19.36
1999-00	12.5	9.6	2.9	21.57
2000-01	12.5	10.0	2.5	22.77

Source: Reserve Bank of India (RBI)

From Table 1, it would appear that the growth in State RD is a direct result of the inability of the States to mobilize sufficient revenues. Although technically correct, this conclusion fails to account for a number of other weaknesses in State finances.

More specifically, during this period interest payments and salary and pension liabilities have registered unprecedented growth:

- pension expenditures of the States have doubled in the past two years;
- the salary bill has more than doubled in the past three years; and
- the interest burden has nearly doubled over the past ten years.

As shown in Table 2, State expenditures on interest and pensions as a share of State revenue have nearly doubled during the last decade. On average, expenditures on salary, pension and interest account for roughly 60 percent of revenue receipts of the States. These are committed expenditures; thus the States currently have limited flexibility to adjust expenditures in response to changing priorities, economic downturns or emergencies.

**Table 2: A Few Key Indicators of State Finances**

Year	Interest + Pension	Tariff recovery
1990-91	17.47	
1991-92	17.59	
1992-93	17.61	82.2
1993-94	18.52	78.3
1994-95	20.57	78.3
1995-96	21.50	77.4
1996-97	23.07	76.7
1997-98	23.77	75.2
1998-99	28.30	70.7
1999-00	36.63	70.2
2000-01	36.61	69.8

The growth in committed expenditures - wages, pensions and interest - in the face of an overall decline in total expenditure as a share of GDP means that States have been cutting discretionary expenditures. As a consequence, over 98 percent of expenditure on education in Karnataka is for teacher salaries. Consequently, very little money is being spent on books, school supplies and operation and maintenance of school buildings. Likewise, over 95 percent of the expenditure in Karnataka on health is for salaries. Again, this implies very little money is being spent on diagnostic equipment, vaccines and medicines. In short, paying for salaries while teachers and doctors lack basic supplies suggests that expenditures on education and health may not be very productive in terms of reducing illiteracy, infant mortality and maternal mortality, etc.

Table 2 also shows that the rate of cost recovery by public sector undertakings (column 2) has steadily declined during this period. The States have to make up the difference through subsidies paid out of current State revenues and, consequently, there is less money available for other important activities of State government. In fact, budgetary subsidies of the State governments currently amount to 8.8 percent of GDP and about 96 percent of revenue receipts.

A possible rationale for such subsidies is to help the poor who otherwise may be excluded from these services if they have to pay the full cost of provision. If the aim is to help the poor, however, these subsidies are poorly targeted. Agriculture and irrigation sectors account for the largest share of State subsidies, followed by elementary education, energy, secondary education and medical and public health. Subsidies to agriculture, irrigation and energy, in particular, benefit the rich as well as the poor. Indeed, evidence shows that per capita subsidies generally show a regressive pattern: States with higher per capita income pay higher subsidies per capita.

On the revenue side, as shown in Table 3, States' own tax-revenues as a share of GDP (column 1) have been rather stable during this period. On the other hand, non-tax revenues of the States as a share of GDP (column 4) have been steadily declining. This is further evidence that low cost recovery by public sector undertakings is a drain on State finances. The share of Central tax revenues (column 2) devolving to the States during the second half of the nineties fell

significantly short of the projections of the Tenth Finance Commission reflecting the decline in the tax-to-GDP ratio of the Center since 1997-98.

**Table 3: Components of State Revenues as a Percentage of GDP**

Year	<u>Tax Revenues</u>			Own Non-Tax Revenue	<u>Non-Tax Revenues</u>		
	Own Tax Revenue	Share of Central Taxes	Total Tax Revenue		Central Grants	Total Non-Tax Revenue	Total Revenues
1990-91	5.3	2.5	7.8	1.6	2.2	3.8	11.6
1991-92	5.5	2.6	8.1	1.9	2.3	4.2	12.3
1992-93	5.3	2.8	8.1	1.7	2.4	4.1	12.2
1993-94	5.4	2.6	8.0	1.8	2.5	4.3	12.3
1994-95	5.5	2.5	8.0	2.1	2.0	4.1	12.1
1995-96	5.4	2.5	7.9	1.9	1.8	3.7	11.6
1996-97	5.2	2.6	7.8	1.7	1.7	3.4	11.2
1997-98	5.4	2.7	8.0	1.6	16.0	3.2	11.2
1998-99	5.3	2.3	7.6	1.4	1.7	3.1	10.7

Source: Reserve Bank of India (RBI)

In short, the States responded to the emerging situation by borrowing to fill the revenue gap rather than making greater efforts to contain expenditure or to augment revenues. As a consequence, the State Debt-to-GDP ratio, which was less than 18 percent as recently as 1996-97, shot up to nearly 23 percent by 2000-01 (see Table 1).

In addition to the growing debt burden on the States, the composition of State borrowings is a matter of serious concern. Rather than borrowing to make needed capital investments in roads, water supply and treatment, irrigation, hospitals and schools, the States are using an increasing share of borrowings to cover deficits in their revenue expenditure budgets. In other words, the States are borrowing to pay for wages and salaries, pensions, subsidies on public sector undertakings and interest on State debt.

Although it is important for States to meet their obligations in this regard, these expenditures do not add to the productive capacity of the economy or increase the ability of the States to repay these loans.

The aggregate Gross Fiscal Deficit (GFD) of the States is a measure of the total State borrowings in a given year. These borrowing are used to cover State Revenue Deficits as well as make capital investments. As shown in column 2 of Table 4, the aggregate GFD of the States has been growing rapidly as a share of GDP since 1996-97.

**Table 4: Gross Fiscal Deficit and Revenue Deficit as a Percentage of GDP**

Year	Gross Fiscal Deficit			Revenue Deficit			Share of RD in GFD		
	Center	States	Combined	Center	State	Combined	Center	State	Combined
1990-91	7.8	2.7	10.6	3.3	0.9	4.2	42.3	33.3	39.6
1991-92	5.6	2.9	8.4	2.5	0.9	3.4	44.6	31.0	40.5
1992-93	5.4	2.8	8.2	2.5	0.7	3.2	46.3	25.0	39.0
1993-94	7.0	2.4	9.4	3.8	0.4	4.2	54.3	16.7	44.7
1994-95	5.7	2.7	8.4	3.1	0.6	3.7	54.4	22.2	44.0
1995-96	5.1	2.7	7.8	2.5	0.7	3.2	49.0	25.9	41.0
1996-97	4.9	2.7	7.6	2.4	1.2	3.6	49.0	44.4	47.4
1997-98	5.9	2.9	8.8	3.1	1.1	4.2	52.5	37.9	47.7
1998-99	6.4	4.2	10.6	3.8	2.5	6.3	59.4	59.5	59.4
1999-2000	5.6	4.6	10.2	3.8	2.9	6.7	67.9	63.0	65.7

Source: Based on RBI statistics

Two trends evident in Table 1 are worrisome. First, as described above, the rapid growth in State Revenue Deficits since 1996-97 point to a number of weaknesses in State finances. In particular, the reduction of discretionary expenditures and the resulting deterioration in the quality of public services. Second, as shown in column 8 of Table 4, State Revenue Deficits as a share of aggregate GFD of the States has increased from nearly 33.3 percent in 1990-91 to 63 percent in 1999-00. In other words, the growing need for States to borrow to cover Revenue Deficits due to committed expenditures, such as salaries, pensions, interest and subsidies, diminishes the ability of the States to borrow for needed capital investments in infrastructure in support of continued economic growth. Taken together the reduction in discretionary spending and the decrease in capital investments as a share of GDP point to a deteriorating quality of public services, now and in the future.

These fiscal trends also negatively impact on women. For example, the middle class is responding to the deteriorating quality by availing themselves of private schools, healthcare, etc. A poor family cannot send all their children to private schools, but they may be able to send one. Given the relative status of men in these societies, in all likelihood this means the oldest male may get a quality education. Furthermore, the relatively high drop rates in some State districts are attributed, at least in part, to the lack of toilets and potable water at public schools. Again, the lack of money for operation and maintenance of school buildings due to the fiscal condition of the States means that efforts to improve female literacy rates may suffer. Similarly, the lack of medical supplies in public clinics and hospitals due to State fiscal stress negatively impacts State efforts to reduce infant and maternal mortality. Clearly, the fiscal health of the States has important implications for gender equity in India.

To the casual observer, the decline in the quality of public expenditure is perhaps most evident in the poor quality of the roads and electric power in India. There also is evidence that those who can afford it – the growing middle class in India – are increasingly using private healthcare and schools in response to the deterioration in the quality of public sector offerings. Meanwhile, businesses are leaving the power grid and using private generators to ensure a steady and reliable supply of electric power. These understandable responses to the declining quality of public expenditure negatively impact on the poorest members of society because they cannot afford to purchase private alternatives.

It is important to note that the current fiscal “crisis” facing the States is largely the result of policy choices made by the States rather than events outside their control. For example, the States adopted the generous salary increases recommended by the Fifth Pay Commission. This resulted in the rapid growth of wage and pension liabilities, which has exacerbated the fiscal problems now facing the States. The States did not have to adopt these recommendations; it was elective on their part. Likewise, the declining rate of cost recovery by public sector undertakings reflects policy choices. States took decisions that increased the cost of service delivery by unnecessarily increasing staffing levels, while tariffs and fees were not increased in tandem to reflect the higher costs of provisions. As a result, these operating losses have to be recovered through budgetary subsidies paid out of State revenues that undoubtedly could be used more productively in other sectors. Apparently, policy decisions have been made for the sake of immediate political gain without recognizing the medium-term fiscal implications of these decisions.

Is a crisis due to the problems with State finances imminent? The combined GFD of the States and Center is approximately 10 percent (column 3 of Table 4). This is the same level that led to the crisis in 1992. Now, a far greater share of total debt is borne by the States than in 1992. State debt is largely financed through internal borrowings. Since there is less external debt exposure today, than in the early nineties, macroeconomic instability – an accelerating rate of inflation, economic recession and growing unemployment - does not appear to be imminent. As long as the Center is willing and able to finance the borrowings of the States without incurring excessive external debt, the States can muddle through. But, muddling through almost surely means a continuing decline in the quality of roads, water supply, education and healthcare and also puts at risk the most important poverty reduction program, robust economic growth. Unless these problems are adequately addressed, over the long haul they will result in growing regional disparities and, perhaps, growing political instability. Though we do not want to be alarmist, a few knowledgeable and mature observers, did express concerns that these negative trends in State finances could threaten the future of the Federation itself if allowed to continue.

### **Is There a Role for USAID in Supporting State Fiscal Management Reform?**

There are a number of significant weaknesses with State finances. The States are borrowing funds at high rates of interest to finance relatively unproductive expenditures on wages, pensions, subsidies to public sector undertakings and interest on state debt. Meanwhile, the States have cut important discretionary expenditures on school and medical supplies to the bone. These cuts reduce the productivity of expenditures on healthcare and education in terms of improving important social outcomes, such as the rate of literacy, infant and maternal mortality. Finally, the share of GSDP that is going to needed capital investments in roads, schools, hospitals, water supply, and treatment is declining as a share of GDP as States borrow to cover Revenue Deficits. In short, the “crisis” of State finances diminishes the capacity of the States and the International donor community to address pressing socio-economic concerns, such as high rates of infant and maternal mortality, illiteracy and poverty.

The Assessment Team concludes that there is indeed a role for USAID to get involved in State Fiscal Management Reform. As described in greater detail below, the Asia Development

Bank and World Bank would welcome USAID involvement that complements their activities in selected States. The GOI places a high priority on restructuring State finances. The States that we visited recognize the need for fiscal reform and would welcome technical assistance and/or capacity building provided by USAID in support of their on-going efforts. Finally, there are a number of critical interventions that are not being covered by the States, GOI or the International donor organizations.

Below is a list of these gaps and complementary activities in State Fiscal Management Reform for USAID consideration. The State Fiscal Assessment Team developed the following list of potential activities based on discussions with representatives of the GOI, the International donor community and State officials. The following list of interventions is not ranked according to priority. We address the issue of priority interventions in the following section.

1. *Civil Service Reform.* There is a need for a Human Resources database. Although the States we visited claim to have a complete list of current employees and their pay grade, this cannot be taken for granted in every state. Apparently, some States do not have such information. Such a database would be an obvious first step in helping a State begin to understand their wage bill and the fiscal implications of various employment and compensation policies. The World Bank thought that this would be especially important for Uttar Pradesh. There already may be a request for this to USAID.
2. *Civil Service Pension Reform.* They suggested that the states do not understand the fiscal costs of pensions and lack the necessary data to produce good forecasts of future pension liabilities. They cannot evaluate the implications of reform options, or even of fiscal decisions. USAID could help one or more States compile the necessary data on current employees and pensioners and provide technical assistance in the development of a model to simulate pension liabilities under current law and proposed law.
3. *Debt and Cash Management.* The impact of different sources of finance on short- and long-run fiscal position. Methods for managing cash flow so that State Treasuries can avoid being in overdraft position.
4. *Implementation of a Medium Term Fiscal Framework.* As previously discussed, each State receiving loan funds from ADB or WB must develop a Medium Term Fiscal Framework (MTFF). These frameworks are very detailed and ambitious. Although ADB and WB may provide targeted technical assistance in support of implementing MTFF, they do not provide on the ground capacity building. USAID could help with capacity building in a variety of areas related to successful implementation of the MTFF, such as general fiscal training, budget management and policy analysis, etc.
5. *VAT Implementation.* The States have agreed among themselves to replace the existing sales tax regime that is their primary source of own-revenue with a sub-national VAT. VAT implementation is scheduled to begin on April 1, 2002. Annex III.C describes a variety of activities that must be completed in order for a State to



- successfully implement the VAT, including drafting enabling legislation, designing tax forms, training administrative personnel, public awareness campaign, register taxpayers, etc. USAID could assist with a number of these activities.
6. *Civil Society.* Oversight of public operations by the private sector. There are many dimensions to this, such as developing local think tanks; working with “watchdog” groups; media development; surveys of service delivery quality; etc.
  7. *Treasury Operations.* Although some progress has been made in computerizing Treasury Operations, it is primarily a data storage and retrieval system. Further computerization would be very valuable. Some examples include the following. All of the Treasuries have not been computerized in Uttar Pradesh and Jharkhand. USAID could provide technical assistance to help with completing computerization of Treasury operations. Uttar Pradesh currently is moving the existing FoxPro-based system to Oracle-based one. USAID could help with completing this transition by, for example, training staff to use the new Oracle-based system. Generally, the States do not use the Treasury data to its fullest advantage to manage cash, monitor expenditures, prevent fraud and abuse, etc. USAID could help selected States, particularly U.P. and Jharkhand, to develop the necessary software to generate management reports and assist with training personnel to produce, interpret, and use these reports for making better decisions. Annex IX gives a more complete description of what is required for modern State Treasury operations.
  8. *Establish Fiscal Analysis Unit.* As previously discussed, the States that we visited do not have a specialized staff dedicated to conducting fiscal analysis on a regular basis. The lack for forward planning may have contributed to the adoption of policies, such as the recommendations of the Fifth Pay Commission, that have led to the present “crisis” of State finances. USAID could assist with establishing a fiscal analysis unit in the Department of Finance in a few selected States. Annex VII gives a more complete description of the role and duties of a fiscal analysis unit.
  9. *Establish Project Appraisal Unit.* The sector departments (roads, water, health, education, etc.) are responsible for developing projects, including the supporting information cost-benefit analysis, cost and time to completion. The Planning Department is responsible for evaluating project proposals, prioritizing them and submitting them for consideration for inclusion in the budget by the Department of Finance. The Planning Departments lack the capacity to evaluate the realism of the supporting documentation for projects. More specifically, they do not have the capacity to evaluate the cost-benefit analyses, cost estimates and time required to complete a project. USAID could provide technical assistance and capacity building in support of the establishment of a Project Appraisal Unit in the Department of Planning in a few selected States.
  10. *Training in State Finances.* USAID could support needed training in the following areas: decentralization, general fiscal training of state officials, budget management and policy analysis.

11. *Decentralization.* The States that we visited, and in particular Jharkhand and Karnataka, are committed to decentralizing important government activities to the third-tier of government (i.e., rural Panchayats and Urban Local Bodies). For example, it is anticipated that the third-tier of government will assume increasing responsibility for water supply and treatment and primary education. As such, these governments will need to develop an autonomous capacity to develop budgets, monitor expenditures, project development and raise revenues. Currently, this capacity is completely lacking in the rural Panchayats and many of the Urban Local Bodies. Therefore, USAID could support decentralization by supporting capacity building and training in these areas.
12. *Strengthening of Management Information Systems.* In general, the States appear to lack management information systems. In Jharkhand, for example, the Department of Urban and Rural Development needs an updated survey of major infrastructure on village and rural Urban Local Bodies. The lack of such data makes it very difficult for the State to assess needs and prioritize projects. The Department of Education does not have a way to collect timely information on the number of students, by age and grade level with associated information on their scholastic achievement, such as level of literacy. Again, this makes it difficult to assess needs and performance and to allocate funds in order to improve educational outcomes and increase accountability. Another glaring problem is the lack of computerization of tax administration. Currently, many States are using manual procedures. Modern tax administration is very dependent on computerization. Computerization of Treasury operations and the development of human and pension databases also fall into this category. Finally, where electronic databases exist, they are not properly utilized as a management tool. Annex VIII describes the status of MIS in the three States. USAID could support the development of one or more MIS and provide training in the use of such data as a tool for making informed decisions. Human resources and Treasury operations would appear to be high priority areas.
13. *Improve Socio-Economic Data.* Much of the basic data used by the States to evaluate socio-economic conditions and progress over the years are taken from the population census. Much critical data is not available annually or during the decennium. Even census reports are published after substantial time lags so that disaggregated district level data pertaining to 1991 has become available only after 1996. As a result, decisions based on such data tend to be flawed and ineffective. Vital indicators for districts based on census data are also not free from errors. Deficiencies occur in census data because of discrepancies in reporting ages as well as missing events at the time of the field interviews. In the period between two censuses, there is no mechanism to obtain reliable indicators on human development. A reliable mechanism must be devised to compile crucial information between censuses so that the success of public policies in education and health can be evaluated. There are several crucial areas for which no information is at present being collected. There is no system developed so far in the country to compute the maternal mortality rate at regular intervals even for states, let alone districts. There is no established and

statistically valid procedure to estimate literate population between censuses. Official machinery at the district level does not collect several kinds of key data that is critical for measuring human development. Data on children's height and weight, the quality of education and health services or the potability of drinking water are not collected frequently. USAID could provide technical assistance and capacity building in the development of regular human development surveys. Also, USAID could provide training to develop the institutional capacity to analyze such data and train policy-makers in the use of such data for fiscal decision- making.

Table 5 below provides a summary of potential interventions, by State. We also indicate potential all India programs that would support specific State interventions and allow USAID to realize cost savings through economies of scale.

**Table 5: Summary of Potential USAID Interventions by State**

All States	Uttar Pradesh	Jharkhand	Karnataka
National Forum on Strengthening MIS Capabilities.	1. HR Database 2. Strengthen Treasury Operations	1. HR Database 2. Strengthen Treasury Operations	1. HR Database 2. TO modernization in progress
National Training Program in State Fiscal Management	Capacity Building for Performance Based Budgeting	Capacity Building for Performance Based Budgeting	Capacity Building for Performance Based Budgeting
National Forum on Fiscal Analysis	Establish Fiscal Analysis Unit	Establish Fiscal Analysis Unit	Establish Fiscal Analysis Unit
National Forum on VAT Implementation	No help needed in tax administration.	Comprehensive Tax Administration System	VAT Implementation: 1. Construct I-O table to computer revenue-neutral-rate 2. Computerization of VAT administration 3. Audit selection software
Building Analytical Capacity	Build analytical capacity to prepare, evaluate and manage tender process.	Build analytical capacity to prepare, evaluate and manage tender process.	1. Est. Analytic Cell in Directorate of Economic Statistics. 2. Office of Finance Controller (capacity building req.) 3. Est. Project Appraisal Unit 4. Est. PSE Analysis Unit
Institutionalize Medium-Term Fiscal Framework	Institutionalize Medium-Term Fiscal Framework	Does not have a MTFF	Analytical research cell to develop MTFP for each department.

### Where Can USAID Add Value in State Fiscal Management Reform?

As previously noted, the current “crisis” of State finances is largely the result of policy choices made by the States. Examples of which include adopting the pay recommendations of the Fifth Pay Commission and allowing the rate of cost recovery among public sector undertakings to decline. In the opinion of the Assessment Team, the most glaring deficiency of State fiscal management is the lack of an institutional structure to support forward looking fiscal decision-making that is well grounded in careful analysis and fact.

Since the early nineties the GOI has pursued economic liberalization that entails the States assuming greater fiscal autonomy. But, the States were ill prepared for their new role. The most obvious need, in our opinion, is for the States to develop institutional structures to support forward-looking fiscal analysis. Such analysis could stop or, at the very least, significantly improve policies that are not consistent with the future fiscal health of the State.

Accordingly, USAID should consider helping a few selected States establish a fiscal analysis unit; further develop high priority databases for fiscal analysis, such as strengthening Treasury operations and Human Resources (HR) database. Resources permitting, USAID also could strengthen the capacity of the States to produce key socio-economic indicators on a regular and timely basis and train policymakers in the value and use of such data in the budget making process. Although outside the mandate of this Assessment, Democracy and Governance may want to consider strengthening civil society to be better consumers of fiscal analysis, as a complementary activity.

There are a number of advantages to the proposed interventions described above. First, they are discrete. In other words, they could work in tandem with the efforts of a multilateral donor engaged in significant lending activity in support of fiscal restructuring in a State. On the other hand, the proposed interventions do not depend on the presence of a large multilateral institution for their success. Second, these interventions represent critical gaps that other donors currently are not filling, but would welcome. Third, the U.S. has tremendous strength in fiscal analysis; computerization of treasury operations; and developing socio-economic data in developing and transitional economies. There are many universities and accounting firms that have tremendous experience in these areas. Thus, they would certainly fall within USAID's comparative advantage. Finally, a fiscal analysis unit and the associated database development could be supportive of USAID's sector activities in selected States, particularly in health, power and irrigation.

Ideally, one would like to improve budget formulation to take into account the fiscal implications of policy proposals by establishing a fiscal analysis unit; improve budget execution by strengthening Treasury operations; and create the capacity to collect key socio-economic data on a regular and timely basis in a few selected States. These are complementary activities that at get at the root of improved fiscal management.

If, however, funding levels do not permit USAID to undertake all three activities in one or more States, then the Team would give priority to establishing a fiscal analysis unit as a standalone activity. A fiscal analysis unit would stimulate demand within government to pursue these other important reforms. Whereas, beginning lower down in the hierarchy of control, by for example strengthening Treasury operations or creating an HR database, may not have the same ripple effect.

If resources are judged insufficient to support establishing a fiscal analysis unit as a standalone activity in one or more States, then USAID should consider one or more of the others as stand-alone activities.

For example, USAID could strengthen Treasury operations in a few selected States. Time and again, the Team was told that the allocation of expenditures described in State budget documents do not accurately reflect the final disposition of funds. In other words, the States need to improve budget execution. Strengthening Treasury operations in the most obvious way to guarantee that monies are spent as intended in the budget. There are other advantages of this activity as well. First, improving budget execution, should contribute to the improvement of the quality of public expenditure. Another advantage is that it would allow USAID to achieve cost savings through economies of scale. In other words, strengthening Treasury operations in one or more States could be replicated in others at very little added cost by convening regular National Forums among State Treasury officials to discuss experiences and potential solutions. The main disadvantage of this intervention as a standalone activity is that it does not address weaknesses in the budget making process, in particular the failure to take proper account of the fiscal consequences of policy decisions, which is the source of the problem.

If resources are judged insufficient to strengthen Treasury operations, then USAID may want to consider assisting one or more States in strengthening their capacity to produce key socio-economic indicators on a regular and timely basis. In addition, USAID could provide support in strengthening the capacity of government officials in analyzing these data and using them in the budget making process.

The major advantages of this intervention are threefold. It could be replicated by USAID in other States at relatively little additional cost to USAID. It would allow States better to identify priority needs and thus support improved budget making. Finally, it may even assist USAID in monitoring their programs. As a standalone activity, however, this intervention does not create the necessary institutional structures for improved fiscal decision-making or budget execution.

In our opinion, capacity building in support of decentralization (number 11 above) would require tremendous amounts of resources. The success of further decentralizing to the third-tier critically depends on rationalizing State finances. Therefore, the Team would not encourage USAID to get involved in such activities at this time. Although a Project Appraisal Unit (number 9 above) is needed, in our opinion it is a lower priority item. We recommend against USAID getting involved in VAT implementation at this time. The resource requirements are significant and there is simply too much policy uncertainty at this time. There are serious reservations among knowledgeable people about the timely implementation of VAT.

USAID also may be considering an indirect or sectoral approach to State Fiscal Management Reform. In other words, USAID could help “fix” the power and health sectors and thereby contribute to State fiscal restructuring. While there are certainly sector problems that need to be addressed as part of a program of fiscal restructuring, the concern is that resources freed-up through a successful intervention in the power sector, for example, may be wasted through tax concessions or unnecessary public sector job creation schemes. As the States pursue sector reforms, they need to develop the capacity and habit of establishing budget priorities that are based in careful analysis. That is one of the primary goals of a fiscal analysis unit.

In the foregoing analysis, the Team has tried to provide a concise statement of the nature of the problem with State finances; describe a menu of possible interventions for USAID consideration; and share with USAID our sense of priority interventions. In order to develop a strategy, USAID expressed a desire to know about other donor activity in this area and the prospects for collaboration and whether the Team believes that the three visited States are representative. We address these important issues in the following two sections.

## **What Are Others Doing in State Fiscal Management Reform?**

The Government of India (GOI), Asia Development Bank (ADB), United Kingdom's Department for International Development (DFID) and World Bank (WB) have programs in place to support state fiscal management reforms. We briefly describe the activities of GOI and International donors below and provide greater detail in Annex IV.

The GOI has created an incentive fund to encourage fiscal correction in the State sector and fiscal management reforms. Each State is required to negotiate a Memorandum of Understanding (MOU) with the Center. According to the terms of this facility, each State is expected to take effective steps for revenue augmentation and expenditure compression over the five-year period of this facility, 2000-01 to 2004-05, to broadly achieve the following objectives: Gross Fiscal Deficit of the States as an aggregate to fall to 2.5 percent of Gross State Domestic Product (GSDP) and Revenue deficit of all States, in an aggregate, to fall to zero.

Given the broad contours of the fiscal objectives sketched above, the State Governments should draw up a Medium Term Fiscal Restructuring Policy (MTFRP). The GOI has a list of specific recommendations that should be part of a State's MTFRP including fiscal objectives and reforms, power sector reforms, public sector restructuring and budgetary reforms. The terms of this facility are provided in Annex XV.

The Asia Development Bank and World Bank are providing structural adjustment loans to selected States in support of State efforts at fiscal restructuring and fiscal management reforms. The loans are disbursed in tranches based on achievement of agreed upon goals or milestones. These milestones are formalized in detailed plans referred to as Medium Term Fiscal Restructuring Plans and are similar in coverage and purpose to the MTFRP required by the GOI.

The U.K.'s Department for International Development (DFID) has concentrated its fiscal policy work in the Indian state of Orissa. In Orissa, DFID, has developed a civil service employee database. This database takes into consideration employee numbers, age, date of service and the expected date of retirement. This database should enable the state government more clearly to determine its human resource needs and to quantify its future pension liabilities. DFID also engages in providing technical assistance on public expenditure management, manpower analysis, sales/VAT (tax administration) and public enterprise reform.

Table 6 below provides a brief summary of International donor activity in State Fiscal Management Reform. ADB and WB welcome USAID's involvement in support of their

activities in the States listed below. DFID did not see opportunities for collaboration with USAID, however no reason was cited.

**Table 6: Summary of Other International Donor Activity**

Donor	State	Status
Asia Development Bank	Gujarat	Completed
	Kerala	Underway
	Madhya Pradesh	Underway
	Karnataka and Uttar Pradesh	Under consideration
DFID	Orissa (TA for fiscal management reform)	Underway
World Bank	Karnataka	Underway
	Uttar Pradesh	Underway
	Rajasthan	Under consideration

One of the advantages of the proposed interventions described in Section F above is that they are discrete. Therefore, they could work in tandem with the efforts of a multilateral donor engaged in a significant lending program in support of State fiscal restructuring. On the other hand, these interventions do not depend upon the presence of a large multilateral institution for its success. Furthermore, a fiscal analysis unit and the associated database development could be supportive of USAID's sector activities in selected States, particularly in health, power and irrigation. Finally, the list of proposed interventions provided above are gaps that other donors are not filling, but would welcome.

### **Are Jharkhand, Karnataka and Uttar Pradesh Representative?**

As previously noted, the State Fiscal Team visited the following three states: Jharkhand, which is a newly formed state; Karnataka, which is a fast-reforming state; and Uttar Pradesh, which is a slow reforming state. The choice of states was intended to reflect the three types: newly formed, fast-reforming and slow-reforming. In order to develop a State Strategy, it is important to know whether these States are representative.

To address this issue, the Team categorized the twenty-five states into their three categories, according to widely held perceptions among Indian observers of State fiscal condition. Table 7 shows how the twenty-five states can be categorized into these three categories along with associated indicators of fiscal distress, specifically percentage of days in a year that the State Treasury is in overdraft position, ratio of revenue-deficit-to-gross-fiscal-deficit and percentage of total state revenue committed to wages, pensions and interest and indicators of socio-economic development, specifically infant mortality rate, maternal mortality rate, female literacy and per capita NSDP.

**Table 7: Statewise Indicators of Fiscal Distress and Socio-Economic Development**

	Percentage of Days Treasury in Overdraft	Ratio of FD-to-GFD	Percentage of Revenue Committed	Infant Mortality 1997	Maternal Mortality 1992	Female Literacy 1991	Per Capita NSDP 1995-96
<i>Slow-Reform States</i>							
Assam	77.75	-26.67		76	544	43.0	6,288
Bihar	22.25	56.77		71	470	22.9	3,524
Jammu & Kashmir	0.00	37.96					
Madhya Pradesh	12.91	69.59		94	711	28.8	6,518
Orissa	53.30	66.21	97.43	96	738	34.7	6,192
Rajasthan	35.16	58.17	94.77	85	550	20.4	6,959
Uttar Pradesh	57.42	74.76		85	624	25.3	5,874
West Bengal	36.81	68.31	152.71	55	389	46.6	8,409
<i>Fast-Reform States</i>							
Andhra Pradesh	40.38	47.04	69.16	63	436	32.7	8,938
Goa	2.75	52.31					
Gujarat	9.34	50.96		62	389	48.6	11,977
Haryana	25.55	68.75		68	436	40.5	13,518
Karnataka	0.00	39.05	63.04	53	450	44.3	9,384
Kerala	56.04	67.39	104.05	12	87	86.2	8,924
Maharashtra	10.16	52.61		47	336	52.3	15,457
Punjab	28.85	69.55		51	369	50.4	16,044
Tamil Nadu	20.88	71.94	85.39	53	376	51.3	10,222
<i>Newly Formed States</i>							
Arunachal Pradesh	0.00	-319.39					
Himachal Pradesh	22.53	61.53					
Manipur	72.25	-101.80					
Meghalaya	0.00	-11.71					
Mizoram	8.79	-33.37					
Nagaland	14.01	5.51					
Sikkim	0.00	37.41					
Tripura	0.00	-78.35					

A good indicator of the degree of fiscal distress that a state is experiencing is the percentage of days in a year that the State treasury is in overdraft. Comparing slow-reform and fast-reform states, it is apparent in Table 7 that the slow-reform States have a greater percentage of days in overdraft. Furthermore, the ratio of revenue-deficit-to-gross-fiscal-deficit is an indicator of the degree to which states are diverting borrowings to cover recurrent expenditures instead of investing in infrastructure investments. Again, as evident in Table 7, the slow-reforming States generally have higher ratios than the fast-reforming States. In other words, slow-reforming States generally are using a greater share of borrowings to cover revenue deficits than fast-reforming states.

In addition, the percentage of total State revenue committed to wages, pensions and interest indicates the quality of revenue expenditure. In many sectors, particularly health, expenditure on wages may not be very productive if it is not matched with significant expenditure on equipment and supplies (diagnostic equipment, vaccines, etc.). Although the data on the share of total State revenue committed to wages, pensions and interest is not complete, the



information provided in Table 7 is suggestive. It appears that slow-reform States tend to spend a greater share of total state revenue on committed expenditures than fast-reform States.

Finally, it is interesting to see if fiscal distress correlates with indicators of socio-economic development. Table 7 clearly shows that infant mortality and maternal mortality tend to be lower in slow-reforming states, while per capita NSDP and female literacy tend to be higher in fast-reforming states.

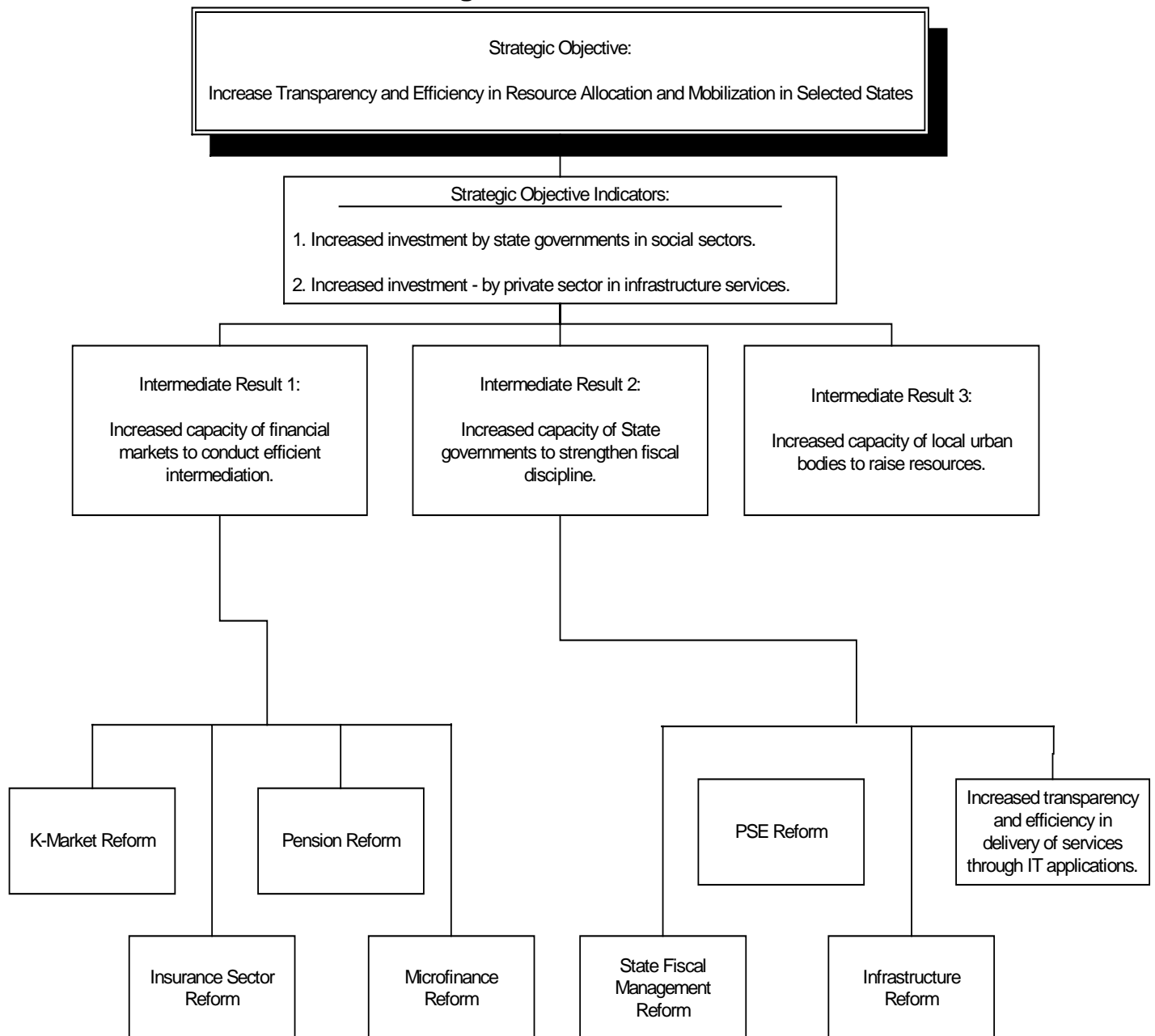
In summary, based on these data it would appear that Uttar Pradesh and Karnataka are representative of slow-reforming and fast-reforming States, respectively. Therefore, conclusions drawn by the Team from field visits about the need for particular interventions in Uttar Pradesh and Karnataka should apply to other States in the same category. Of course, there always will be State specific idiosyncrasies. While, for example, Uttar Pradesh does not express a desire for technical assistance and capacity building in tax administration, other slow-reforming States may desire it.

The newly formed States require special mention. The Team could not obtain data for the “newly formed States,” therefore they are not included in Table 7. In addition, we have included many of the Northeastern States in the “newly formed State” category. Although the data in Table 7 are incomplete, the fiscal distress indicators suggest that they are in relatively good fiscal condition. They are placed in the “newly formed state” category because they generally are believed to lack capacity and to rate low relative to other States in terms of socio-economic development.

### **The Relationship Between the IR and the SO**

We conclude this Assessment by briefly describing how increasing the capacity of State governments to strengthen fiscal discipline, which is a proposed Intermediate Result (IR) in the Mission’s Five-Year Strategy, relates to the high-order Strategic Objective (SO) to increase transparency and efficiency of resource allocation and mobilization. The SO and IR for the Economic Growth Activity are summarized in Figure 1 below. It is important to note, however, that this organizational chart is based on our understanding of a draft version that may very well have changed since our departure.

**Figure 1: Economic Growth**



At the State level, there are currently, major structural weaknesses in State public finances that are preventing Indian States from effectively allocating and mobilizing resources. Investment in social and physical infrastructure is the major victim of the lack of fiscal discipline among the States. Currently, Indian State governments are caught in a vicious cycle of fiscal crises, low growth and deteriorating social and economic amenities.

Although the State deficit stems from the failure of the States to mobilize sufficient resources as evident in the low rate of cost recovery by public sector undertakings, the State response to the resulting fiscal stress is harmful to the future prospects of India. For example, the bulk of State resources are going to the payment of wages and salaries, civil service pensions, subsidies to public sector undertakings, in particular power, and interest on mounting State debt. Furthermore, borrowing to cover Revenue Deficits reduces the capacity of the State to borrow for important capital investments in both social and physical infrastructure. Reduced investment in infrastructure, especially social infrastructure like health and education, adversely affect the poor who are dependent on public services. Increased borrowing by the government also limits the private sector's ability to raise funds for investment.

These structural weaknesses in State finances stem from decisions taken by the States and reflect the absence of forward looking capacity to analyze the fiscal consequences of policy, regulatory and procedural decisions. The primary focus of State governments is on administrative approval of schemes/programs and the level of disbursement. Little emphasis is placed on cost-benefit analysis of programs, the quality of expenditure and attainment of objectives. For example, the Department of Finance in Uttar Pradesh with a population of 166 million (equivalent to the seventh largest nation in the world) does not have an institutional structure dedicated to fiscal analysis to inform decision-making on revenue and expenditure policies of the State. Poor management information systems exacerbate this weakness. In Karnataka, one of India's more reform-minded States and the 'Silicon Valley' of India, the government's statistical department for the entire State has only three computers.

Other weaknesses related to State fiscal management include: (a) poor compliance and lack of innovative approaches to tax and non-tax resource mobilization; (b) continued support to unsustainable patterns of investment and expenditure; (c) inefficiency of public sector enterprise performance (that are currently supported through large State subsidies); and (d) inability to recover costs from public sector enterprises. Much of the above are the result of an absence of analytical capability and poor MIS. Capacity building of State finance, including Treasury operations, and planning departments – the two centralized decision making bodies in the states – thus, are critical if States are to restructure their finances with a minimum adverse impact on the poorest members of society.

Finally USAID asked the Team to relate the IR - increasing the capacity of State governments to strengthen fiscal discipline - to good governance. Box 1 provides a handy working definition of good governance.

Box 1

“Good governance is epitomized by predictable, open and enlightened policy making, a bureaucracy imbued with a professional ethos acting in furtherance of the public good, the rule of law, transparent processes and a strong civil society participating in public affairs.” Source: *United Nations website*.

The Team has given priority to three potential interventions: establishing a fiscal analysis unit, strengthening MIS capabilities by modernizing treasury operations and developing a HR database and increasing the capacity of State government to produce regular and timely socio-economic indicators by district. In our opinion, these potential interventions are supportive of good governance.

Establish a fiscal analysis unit would help make the budget formulation process more predictable, open and enlightened. The failure of State government to evaluate the near term fiscal implications of policy choices is clearly not enlightened policy making or in furtherance of the public good. As previously discussed, actual State expenditures bear little resemblance to planned expenditures as described in the budget. Poor budget execution is not only evidence of poor management, but it also undermines the ability of civil society to participate meaningfully in public affairs. In order for civil society to participate in public affairs, it is helpful if government processes are transparent. For example, it is valuable to know how much the government is spending on education and health, the number of employees, etc. The State budget document is the public’s primary source of information on the activities on State government. Thus, strengthening budget execution in selected States, by, for example, modernizing treasury operations, will improve the quality of expenditure by ensuring that money is spent as intended; increase transparency by ensuring that there is an appropriate correspondence between the budget and actual expenditures; and strengthen civil society by providing them with more accurate information on State activities. In addition, making State budget information more accessible to the public would help strengthen the role of civil society in public affairs. This could be accomplished by, for example, increasing the general fiscal knowledge of NGOs and journalists. Finally, civil society could participate more meaningfully in public affairs if they have access to regular and timely information on key socio-economic indicators.